

STATE OF CALIFORNIA  
BOARD OF EQUALIZATION

570.1173

In the Matter of the Petition	)	
for Redetermination Under the	)	DECISION AND RECOMMENDATION
Sales and Use Tax Law	)	OF HEARING OFFICER
	)	
G--- COMPANY	)	
	)	Account No. SZ OHB XX XXXXXX-040
	)	
<u>Petitioner</u>	)	

This matter came on regularly for hearing in Sacramento, California, on March 30, 1976, before Jack D. Paulson, Hearing Officer.

Appearances

For the Taxpayer:

Mr. R--- E. P---  
Consultant, State and Local Taxes

Mr. A. S---  
Associate Tax Counsel

Mr. P--- M.  
Attorney at Law

For the Board:

Mr. Sam Stein  
District Administrator

Mr. Dan M. Allen  
Principal Tax Auditor

Protested Items  
(Period 1/1/67 to 12/31/70)

Item A – Rental receipts from U. S. Air Force Contract No 34 (601) 23609 not reported	\$1,225,295
Item B – Sale of data logging and control computer system to F--- Corporation not reported	246,529
Item C – Receipts received from B--- R--- not reported	126,845
Item D – Cost of materials for 9 tape handlers used by G--- N--- E--- Division not reported	66,596

Contentions of Taxpayer

Item A – Rental receipts from Contract 34(601)23069 are not subject to tax (rental to U.S. Government).

Item B – Sale of tangible property to F--- was all for resale. Also any alleged use in California is exempt under section 6009.1. If taxable, only one percent additional tax is due in view of the credit available under section 6406.

Item C – All transactions with B--- R--- were sales for resale.

Item D – The unreported tape handlers were replacements for defective merchandise and are not subject to tax pursuant to the provisions of Regulation 1655.

Summary of Petition

Taxpayer (G---) is the largest manufacturer of electrical and electronic equipment in the U. S. It is engaged in the development, manufacture and sale of apparatus, equipment, supplies, and appliances for the generation, transmission, utilization and control of electrical power. Productions range from lamps, household appliances, and x-ray equipment to industrial and utility machinery and jet engines.

Subsequent to the preliminary hearing, Mr. L--- submitted substantial information to support the positions taken with respect to the various protested transactions.

Item A – This protested item involves a contract entered into between G--- and the Air Force for the lease to the Air Force of certain equipment. The contract was for a fixed-term, neither party having the right to terminate. The property automatically passes to the lessee upon the final rental payment following the payment of a nominal amount. By memorandum dated March 30, 1970, Glenn L. Rigby, Tax Counsel, concluded that the contract was a true lease pursuant to the law regarding leases of tangible personal property effective August 1, 1965. Accordingly, since G--- is the manufacturer of the items subject to the lease, it was required to pay tax measured by its rental receipts.

Item B – The F--- transaction was based on the contractual arrangements settled in late 1968 and implemented through a letter of intent from F--- in February 1969, supported by a purchase order and supplements to that order. G--- was to sell a process computer to F--- f.o.b. Phoenix for resale by F--- to G--- as part of F---'s construction of G---'s Midwest fuel recovery plant in ---, Illinois. Job delivery was scheduled on or before December 13, 1969. Under these arrangements, it was clear to G--- that the Illinois tax would be applicable and provision was made for the tax which was collected from G--- by F--- and paid to the State of Illinois in the amount of \$9,861.16.

The sale in Phoenix by G--- to F--- took place in the Fall of 1969 (G---, Phoenix' invoice to F--- was dated October 1, 1969), and was considered an exempt sale for resale by G---.

For reasons not apparent at the time of the contract, substantial delays were incurred by F--- in its construction of G---'s plant in ---, Illinois. For this reason the computer's delivery date in Illinois was moved to March 1970. However, instead of retaining the computer in Phoenix, an interim measure was adopted which resulted in the shipment of the computer to F--- in care of G---'s N--- Division in [California], on December 16, 1969.

Information submitted in a letter from G--- to Mr. L---, dated July 28, 1976, shows that the computer was designed to monitor fuel recovery and related operations of the Illinois plant. In addition to special design features, the computer required essentially two programs, one was entered in the G--- facility in Phoenix and the second was entered in [California] shortly after the computer's arrival. The basis for including the sale of the computer in the measure of tax was in part based upon the conclusion that the entering of the program in [California] constituted a taxable use in California.

The information submitted shows that the computer could not be functionally operated nor functionally tested in [California]. The reason for this was that an operational test required the hook-up of over 500 leads to various sensors through the fuel recovery system being constructed in Illinois. There was no fuel recovery or similar system in [California], so it was not possible to connect the computer for such testing and use until after its arrival in Illinois. The computer was repackaged in June 1970 and shipped to Illinois on January 11, 1971.

1. Pursuant to questions asked by the hearing officer, the information furnished by G--- shows that neither the Atomic Energy Commission nor any other regulatory agency required any changes to be made in the computer after it was sold to F---.

2. The originally executed maintenance agreement was on G---'s N--- E--- Division's purchase order No. XXX-T-XXXX, dated February 2, 1970, issued to the G--- P--- C--- Department, Phoenix, Arizona.

The maintenance agreement was transferred to the G--- I--- Sales Division, Chicago, Illinois, on June 30, 1970, consistent with national sales agreement requirements. The maintenance charges relating to maintenance in [California] (maintenance was performed by G---'s Installation and Service Engineering Dept. from [California 2]) were invoiced through G---'s intracompany billing routine. The bookkeeping for the maintenance was performed at [California].

3. The software capabilities of the computer are limited to functions surrounding the Illinois plant operation. According to the information furnished, "not free time" software is provided to allow on-line computer use. In other words, this computer was not designed to have any other capability than to monitor uranium fuel recovery. Therefore, it could not have been functionally used in [California], where no fuel recovery operation existed. Property taxes were paid by G--- N--- E--- Division at [California], and included in the G--- N--- E--- Division Unfinished Plant account.

4. No depreciation was charged against the computer while in California.

5. The computer was not used on California for instructional purposes.

Item C – In 1965 G--- purchased the B--- - R--- Corporation (BR) processed control computer business and later entered into an agreement to service the computers upon which BR had existing service contracts or were on lease from BR. Computers were in place at 50 locations; six in California, with the remainder scattered throughout the United States and foreign countries. The fact that only six units were located in California was alleged in G---'s petition for redetermination. A copy of the service agreement in question was submitted by the taxpayer. It was alleged that all of the services included as taxable in the determination were sold for resale.

In support of this position, Mr. L--- furnished the hearing officer a copy of an actual invoice issued by BR to a California customer as part of the resale process. The invoice, No. XXXXX, is dated 11/8/67, and is marked taxable. It is from BR to S--- Company of California, Inc., ---, California. The description of the services provide "lease and maintenance of B--- - R--- 340 Computer System at --- Refinery for the month of November 1967 \$3,707.99, plus California State sales tax in the amount of \$139.60, measured at 5% on a lease rental amount of \$2,754.99, making a total sale of \$3,847.59."

Item D – This transaction involves nine tape handlers. The information available indicates that the tape handlers which were replaced by the ones in question were sent to California in May and July 1967, where they were apparently used until April 1968, when they were considered defective and replaced. The replacements were manufactured by G---. G--- contends that since the defective units were returned to the computer operations in Phoenix, Arizona, that such return should be deemed a return of defective parts pursuant to section (b) of Regulation 1655, and accordingly, full credit should be allowed for the tax paid on the original tape handlers.

#### Analysis and Conclusions

Item A – G--- has filed numerous claims for refund with respect to Air Force Contract No. AF XX(XXX)XXXXX. These are being processed through our Audit Evaluation and Planning Unit to conform with the decision in United States v. State Board of Equalization, USDC Civil No. 2568-R. To the extent that any amounts are included in this determination which were deemed exempt under the above-mentioned litigation, they should be deleted from the determination.

Refunds of tax and/or interest which have been paid with respect to or pursuant to the Air Force contract will be handled through the Evaluation and Planning Unit.

Item B – In the hearing officer's opinion the F--- transaction should be considered a sale for resale not taxable to G--- or to F---. In the hearing officer's opinion it has been documented that the use in California was related only to programming the computer for use outside this state because no installation in California was set up for either testing or for the production use of the computer. This is so because the computer was specifically designed for use at the Illinois plant and was limited to such use. Therefore, the only use in California would be exempt under Section 6009.1.

In view of the conclusion reached herein, it will be unnecessary to rule on the second contention of the taxpayer that an offsetting credit should be allowed for tax paid to Illinois. It will also be unnecessary to comment on the fact that at the time of sale to F---, there was no intent on the part of G--- or F---, based upon the documents, that the property would be used in California as contemplated by the Use Tax Law.

Item C – Under the services agreement, G--- undertook to perform the system's installation and acceptance and/or maintenance and other services for BR. It also specifically agreed to perform these services as subcontractor and under the general direction of BR.

The agreement also sets forth in Schedule A the locations of and the name of each lessee of the various computers in question. As alleged in the petition for redetermination, only six were located in California.

As confirmed by the invoice to S---, BR considered the lease to be taxable and billed sales tax on the taxable portion. In view of the above-mentioned evidence it is the hearing officer's opinion that in fact the services were sold for resale. It is not known whether BR reported the tax to the board. However, in view of the billing as evidenced by the invoice to S---, the tax would normally have been reported and paid to the board. If not so paid, it would certainly have been included in any audit of BR.

In view of the above-mentioned conclusions, this item should be deleted from the determination.

Item D – Nothing in the regulation or law provides for a credit for defective merchandise under the conditions outlined. A defective merchandise credit is applicable with respect to purchases from a retailer. In the situation presented, allegations are not made that the raw material or components purchased by G--- were defective. G--- merely manufactured tape handlers for its own use and transferred them between divisions. Such transfer does not constitute a sale, and accordingly, there would be no basis in the law or under the regulation to consider such transfer as being within the defective merchandise credit provision of Regulation 1655. Under the circumstances there is no basis for recommending any adjustment to this item.

Recommendation

- A. Cancel any amount included in the determination which is not covered by or considered in the resolutions of the various claims being processed by the board's Audit Evaluation and Planning Unit.
- B. Delete this item from determination.
- C. Delete this item from determination.
- D. No adjustment recommended.

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JACK D. PAULSON, HEARING OFFICER

2 SEPT 1976

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Date